

PUBLIC UTILITIES COMMISSION

505 VAN NESS AVENUE

SAN FRANCISCO, CA 94102-3298



July 20, 2004

Agenda ID #3745
and
Agenda ID # 3746
Ratesetting

TO: PARTIES OF RECORD IN APPLICATION 00-11-038 ET AL.

Enclosed are two proposed decisions: the proposed decision of Administrative Law Judge (ALJ) Peter V. Allen previously designated as the principal hearing officer in this proceeding and the alternate proposed decision of Commissioner Loretta Lynch. These proposed decisions will not appear on the Commission's agenda for at least 30 days after the date it is mailed. This matter was categorized as ratesetting and is subject to Pub. Util. Code § 1701.3(c). Pursuant to Resolution ALJ-180 a Ratesetting Deliberative Meeting to consider this matter may be held upon the request of any Commissioner. If that occurs, the Commission will prepare and mail an agenda for the Ratesetting Deliberative Meeting 10 days beforehand, and will advise the parties of this fact, and of the related ex parte communications prohibition period.

The Commission may act at the regular meeting, or it may postpone action until later. If action is postponed, the Commission will announce whether and when there will be a further prohibition on communications.

When the Commission acts on the proposed decision or the alternate, it may adopt all or part of the decisions as written, amend or modify them, or set them aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the proposed decision and alternate proposed decision as provided in Article 19 of the Commission's "Rules of Practice and Procedure." These rules are accessible on the Commission's website at <http://www.cpuc.ca.gov>. Pursuant to Rule 77.3 opening comments shall not exceed 15 pages. Finally, comments must be served separately on the ALJ and all Commissioners, and for that purpose I suggest hand delivery, overnight mail, or other expeditious method of service.

/s/ ANGELA K. MINKIN
Angela K. Minkin, Chief
Administrative Law Judge

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Decision **PROPOSED DECISION OF ALJ ALLEN** (Mailed 7/20/2004)**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Application of Southern California Edison Company (E 338-E) for Authority to Institute a Rate Stabilization Plan with a Rate Increase and End of Rate Freeze Tariffs.

Application 00-11-038
(Filed November 16, 2000)

Emergency Application of Pacific Gas and Electric Company to Adopt a Rate Stabilization Plan. (U 39 E)

Application 00-11-056
(Filed November 22, 2000)

Petition of THE UTILITY REFORM NETWORK for Modification of Resolution E-3527.

Application 00-10-028
(Filed October 17, 2000)

(See Appendix B for a list of appearances.)

**OPINION IMPLEMENTING A PERMANENT ALLOCATION
OF THE ANNUAL REVENUE REQUIREMENT DETERMINATION
OF THE CALIFORNIA DEPARTMENT OF WATER RESOURCES**

I. Summary

The primary purpose of this decision is to adopt a cost allocation methodology that will be applied to the revenue requirement of the California

Department of Water Resources (DWR) for its power purchases in 2004 and beyond.¹

The methodology we adopt is effectively a compromise between the proposals presented by the parties. We do not adopt the proposed settlement agreement,² nor do we adopt any one party's litigation position. The allocation methodology we adopt leaves the variable costs of the DWR contracts as previously allocated in D.02-09-053, and separately allocates the fixed costs of the DWR contracts as follows: PG&E 43.75%, SCE 43.75%, and SDG&E 12.5%.³ Consistent with D.04-01-028, this methodology is applied retroactively to January 1, 2004. (*Id.*, p. 3.)

II. Background

This Commission has previously established allocations for the DWR revenue requirement for 2001-2002 (see, D.02-02-052), and for 2003 (see, D.02-12-045). For 2004, on an interim basis, we have continued to use the 2003 allocation methodology. (D.04-01-028, as modified by D.04-02-028.) In this proceeding, we are adopting an allocation methodology applicable to 2004, but also applicable for the remaining term of the DWR power purchase contracts.

¹ For more background on DWR's power purchase program and revenue requirement, and on the relevant statutes, see Decision (D.) 02-02-052, pp. 6-12.

² The settlement agreement was proposed by Pacific Gas & Electric Company (PG&E), Southern California Edison Company (SCE) and The Utility Reform Network (TURN). It was generally supported by the Commission's Office of Ratepayer Advocates (ORA), and strongly opposed by San Diego Gas & Electric Company (SDG&E).

³ D.02-12-045 used the terms "fixed" and "variable" costs. In this proceeding, these terms were largely referred to respectively as "non-avoidable" and "avoidable" costs.

Based upon DWR's original 2004 revenue requirement determination, the parties litigated the methodology to be used for the permanent allocation. Opening and reply testimony was submitted by PG&E, SCE, SDG&E, ORA, and DWR, evidentiary hearings were held, and opening and reply briefs were filed by the three utilities.⁴ Subsequent to the submission of briefs, DWR submitted a supplemental determination, modifying its revenue requirement for 2004.⁵ Pursuant to an ALJ Ruling, the parties submitted comments addressing the supplemental determination. This decision allocates the 2004 revenue requirement of DWR as modified by the supplemental determination.⁶

On April 22, 2004, the settling parties submitted a motion for leave to submit their proposed settlement agreement. Parties submitted comments and reply comments on the proposed settlement, along with related procedural motions. SDG&E consistently and vociferously opposed the proposed settlement, while ORA generally supported it. The assigned ALJ allowed for submission of the proposed settlement, granted SDG&E's request for evidentiary hearings, and ordered the settling parties to present witnesses for cross-examination. Evidentiary hearings on the proposed settlement were held on

⁴ ORA submitted only an opening brief, and DWR submitted a memo concurrently with the parties' reply briefs.

⁵ The effective submission date of the supplemental determination was April 22, 2004. (See, DWR Letter Memorandum dated May 17, 2004.)

⁶ One difference between the two is that they are based on different modeling runs. The original revenue requirement determination was based on Prosym Run 43, while the supplemental determination is based on Prosym Run 45. The allocation adopted today is based on Prosym Run 45, as reflected in Appendix A.

June 14 and 15, 2004, with parties submitting opening briefs on the proposed settlement on June 25, 2004, and reply briefs on July 2, 2004.

III. Permanence of the Allocation

All parties agree that the allocation methodology that is adopted here should be permanent. (See, e.g., SCE Opening Brief, p. 43, PG&E Opening Brief, p. 4, SDG&E Opening Brief, pp. 2-3.) We concur. Annual litigation of the allocation methodology is not an efficient use of the parties' or the Commission's time and resources. Prior to today, the relatively uncertain and unstable nature of the electricity market, and the newness of the DWR contracts themselves, made us reluctant to adopt a permanent allocation methodology. The Commission and the parties have now gained enough experience, particularly with the DWR contracts, that it is appropriate to make our allocation methodology for the DWR revenue requirement permanent, and eliminate the annual litigation process we have used to date.

IV. Proposed Settlement Agreement

Given the broad-based support among the parties for the proposed settlement agreement, we must give it serious consideration. At the same time, we acknowledge SDG&E's questioning the legitimacy of a settlement entered into by two parties (who already largely agreed with each other) in which those two parties agree to shift costs to a third, non-settling party. (SDG&E Comments re Proposed Settlement, p. 27.)

The proposed settlement divides DWR's revenue requirement into three categories, referred to as: (1) as DWR's contract costs; (2) DWR's other power costs; and (3) planned changes in power charge accounts. (Motion of Settling Parties, p. 4.) Each category receives its own allocation approach.

The proposed settlement would start by allocating DWR's contract costs on the same basis that the contracts were allocated for operational purposes in D.02-09-053. This method is generally referred to as the "cost-follows-contracts"

or “CFC” methodology, and was generally advocated in the litigation positions of PG&E and SCE.

This initial CFC-based allocation would then be adjusted by “Fixed Annual Adjustment Amounts.” (Brief of Settling Parties, pp. 8, 14.) According to the Settling Parties, using these fixed annual adjustment amounts results in the projected “above market costs” of DWR’s long-term contracts being allocated to the customers of PG&E, SCE and SDG&E based on utility allocation percentages of 43.6%, 42.6%, and 13.8%, respectively.⁷ These percentages “[A]re designed primarily to constitute a reasonable reflection of the relative net-short positions of the three utilities that DWR initially sought to serve when it entered into its contracts, and the other equity “yardsticks” advanced by the parties to this proceeding.” (*Id.*, p. 8.)

The same utility allocation percentages would be applied to DWR’s other power costs, which includes all of DWR’s administrative, general, and extraordinary item expenses, and any new cost categories specified by DWR not directly related to a specific contract. (*Id.*, p. 7.)

For the third category, planned changes in power charge accounts, which reflects the planned annual changes in the operating reserves maintained by DWR, different percentages would be applied, of 44.4% for PG&E, 45% for SCE, and 10.6% for SDG&E.

The proposed settlement agreement is in fact an odd hybrid. It starts from a CFC approach, which in its pure form has the advantages of simplicity, ease of administration, and not requiring the use of confidential information. A pure

⁷ These annual adjustments are reduced to zero for the years 2012 and 2013.

CFC approach does, however, have one serious problem – it is simply not equitable, as even its advocates will admit. (SCE Opening Brief, p. 29.)

The benefits and flaws of a CFC approach are well summarized by SCE's witness:

As Edison's testimony states, CFC allocation methodology provides certain operational and administrative benefits that none of the other allocation methodologies provide, but we were also very clear in our testimony that it is not cost-based, but neither are the other allocation proposals; it is not equitable, and neither are most of the other allocation proposals; but that in -- in large, when you look at all the factors considered, it's a reasonable way to allocate these costs for what is a very difficult decision the Commission has to make. (SCE witness Cushnie, Transcript p. 7237.)

The allocation of fixed costs resulting from a CFC approach is somewhat arbitrary, as we noted in D.02-12-045:

Since DWR signed contracts for a statewide need, allocating the fixed costs of contracts to utility service territories based upon geographic location does not match how or why those contracts were obtained. It would be arbitrary and unfair for one or more service territories to end up with a disproportionate number of high-priced contracts when DWR was not trying to balance costs among service territories. (*Id.*, p. 11.)

In order to remedy this problem with the CFC approach, the proposed settlement adjusts the CFC allocation through the fixed annual adjustment amounts. The logic behind this approach is explained:

The customers of the utilities must take power from DWR, and must bear the costs of that power. To the extent that the costs are equal to the market costs for the power, there is no burden associated with the requirement that customers take DWR's power. It is only to the extent that the costs of the power exceed its market value that a burden is imposed on customers.

Therefore, in allocating the DWR Annual PCRR, the Settlement Agreement focuses on achieving a result that fairly allocates the above-market component of the DWR contract costs to the customers of the three utilities. Under the Settlement Agreement, a CFC allocation is adjusted, through the use of Fixed Annual Adjustment Amounts, so that each utility's customers are expected to bear a market price for the power they receive from DWR, plus a fair share of the above-market component of DWR's costs. (Brief of Settling Parties, p. 15.)

While the underlying logic - attempting to fairly allocate the above-market costs of the DWR contracts - is sound, the actual method the proposed settlement uses to calculate above-market costs is flawed.

As SDG&E points out, "The calculation of the above-market costs of a contract requires forecasts of a variety of assumptions, including gas and electric market prices and conditions." (SDG&E Comments, p. 15, citing Exhibit 04-21.) SDG&E goes on to list some of the other factors for which assumptions would need to be made, particularly those relating to the market value of the DWR contracts. (*Id.*, pp. 15-16.)

In D.02-09-053, this Commission raised similar criticisms of the above-market cost metric proposed by SCE as a basis for determining the ultimate reasonableness of the various contract allocation proposals in that proceeding:

SCE's methodology relies on several calculations and projections that are based on subjective assumptions, including a forecast of future market prices (forward price curve) based on broker quotes and (after 2007) growth rate assumptions, and calculations of future hourly market prices that are derived from a regression analysis of the forward price curves and historical market prices. (D.02-09-053, p. 31.)

Hence, SCE had originally proposed (as one alternative) that there should be an annual determination of above-market costs. (See e.g., SCE Opening Brief, p. 16.) The proposed settlement, however, is based upon a one-time forecast of above-market costs, applicable for the duration of the DWR contracts. SDG&E vigorously attacks this aspect of the proposed settlement, arguing that use of a locked-in ten-year forecast of above-market costs is unreasonable. (SDG&E Brief re Proposed Settlement, pp. 24-32.) There is some validity to SDG&E's criticisms. As SCE originally stated in support of its litigation position: "An annual determination of the AMC costs on a forecast basis is necessary as a ten-year projection of such costs will be unreliable in the later years." (SCE Opening Brief, p. 7, fn. 6.)

In addition to the difficulty of calculating the above market costs, the methodology does not (and cannot easily) reflect the actual value of a particular contract or contracts. SDG&E argues that the methodology used by the settling parties does not explicitly value capacity or ancillary services, among other things (SDG&E Brief re Proposed Settlement, pp. 26-27), nor does it reflect the value of the contracts in the context of the utility's supply portfolio (SDG&E Comments, p. 16). The settling parties note that their methodology does not value the dispatchability of contracts (see, e.g., Reply Brief of Settling Parties, pp. 13-14), and while this may tend to favor SDG&E, it reflects yet another problem with attempting to calculate the above-market component of the contracts.

Overall, the forecast of above-market costs used in the proposed settlement is simply not good enough to provide a principled basis for allocating the costs of the DWR contracts.

A more serious problem with the proposed settlement is its fundamental reliance upon the relative net-short positions of the three utilities for the 2001-2002 time period. The “Utility Allocation Percentages” that form the basic yardstick for the proposed settlement “[A]re designed to constitute a reasonable reflection of the relative net-short positions of the IOUs that DWR initially sought to serve when it entered into its contracts.” (Motion of Settling Parties, p. 6.)⁸

The propriety of allocating future revenue requirements on the basis of forecasts of the utilities’ net-short positions for 2001-2002 was actively litigated. (See, e.g., PG&E Opening Brief, pp. 14-19.) The basic idea behind the use of the net-short forecasts is that DWR was procuring power to fill the net-short positions of the utilities, creating a causal link between the net-short positions and the size and cost of the contracts themselves. The net-short forecasts are in essence treated as a proxy for the state of mind of DWR at the time it entered into the contracts that are at issue here.

The main problem with use of the individual net-short forecasts for allocating the costs of the contracts is the fact that DWR’s purchases and contracts were made to cover the *aggregate* net short position of all three utilities,

⁸ The Motion of the Settling Parties states that it used “three principle net short allocation percentages presented in the proceeding:” SCE’s proposed net short percentages based on D.02-02-052, PG&E’s percentages based on DWR’s Prosym Run 19g, and percentage shares derived from the Nichol Declaration. (*Id.*, p. 14.) The first source addresses the 2001-2002 net short, while the other two contain forecasts for both 2001-2002 and for future years. The Motion, however, is not clear what forecast or forecasts in Prosym 19g and the Nichols Declaration it used, or what weight was given them. Based on the language of the Motion itself we can only conclude that the utility allocation percentages are largely, if not totally, based upon the 2001-2002 net short.

not the *individual* net short of each utility. (See, e.g., D.02-12-045, p. 12.) Contracts were signed to meet statewide needs, not the needs of individual utilities. (*Id.*, p. 11.) Second, a forecast of the net-short for only 2001 and 2002 does not actually reflect what DWR may have expected each utility's needs (and other sources of electricity, such as hydro) to be over the life of the contracts. (See, D.02-09-053, p. 30; SDG&E Reply Comments, pp. 5-6.) Also, as we noted in D.02-12-045, the amount of energy actually delivered to each utility's customers by the remaining DWR contracts does not necessarily match each utility's net short. (D.02-12-045, pp. 11-12.) While superficially appealing, the net short forecasts for 2001-2002 do not provide a principled basis for allocating the costs of the DWR contracts.

Accordingly, we do not approve the proposed settlement agreement.

V. Litigation Positions, Past Allocations, and Fairness Metrics

Since we have rejected the proposed settlement agreement, we next consider the litigation proposals of the parties. Unfortunately, we also find the litigation proposals to be unsuitable for permanently allocating the costs of the DWR contracts.

The litigation proposals of PG&E and SCE, while not identical, share a number of flaws. Among other things, the PG&E and SCE proposals are based upon the inequitable CFC methodology, rely upon flawed estimates of above-market costs, and invite significant re-litigation. The proposals of ORA and SDG&E are based upon the allocation methodology adopted for 2003 in D.02-12-045. However, the ORA proposal is somewhat incomplete, and SDG&E incorporates additional self-serving resource assumptions in its proposal.

We will, however, take as our starting point the *pro rata* allocation methodology we adopted in D.02-12-045. This allocation methodology is generally advocated in the litigation positions of ORA and SDG&E, and partially supported by the litigation position of PG&E. In D.02-12-045, the adopted methodology pooled the costs of the DWR contracts, reflecting the fact that DWR's contracts were signed with the intent to meet the aggregate need of the utilities. (*Id.*, pp. 11-13.) Aggregating the costs of the contracts accordingly matches the way the costs were actually incurred, and also spreads the pain of those contracts that are particularly expensive. (*Id.*)

After pooling the DWR contract costs, D.02-12-045 then allocated the costs to the customers in proportion to the quantity of energy supplied by DWR to each utility for 2003, as forecast by a modeling run performed by DWR. The use of supplied energy as the basis for the allocation was appropriate, as it allocated the costs of the contracts proportionally to the benefits received from the contracts.

D.02-12-045 used the most current forecast for which there was an adequate record. (*Id.*, pp. 27-28.) Given that the forecast was for one year only, this approach had a reasonable probability of accuracy. However, in this proceeding we need to find a basis for allocating the costs of the DWR contracts through 2013, when the last of the contracts expire. Using a forecast of supplied energy over a relatively long time period, however, raises some of the same concerns we have expressed regarding the accuracy of the above-market cost forecast.

In addition, it is not clear what forecast should be used. One approach would use the most recent DWR forecasts of supplied energy for the relevant time period. (See, e.g., SDG&E Opening Brief, p. 9.) This approach, by using the

most recent forecast reflecting the latest data and assumptions, would hopefully be the most accurate. Even so, its accuracy is uncertain at best. In addition, SCE argues that the use of current forecasts requires the use of confidential information, making it difficult for parties to review and confirm the results of the allocation methodology. (SCE Opening Brief, p. 32.)

On the other hand, it is also possible to use a forecast based on a model used by DWR back when it was entering into the contracts. (See, e.g., PG&E Opening Brief, p. 18.) This, like the settlement's use of the 2001-2002 net short figures, is an attempt to mirror the state of mind of DWR at the time it executed the contracts. It is, however, an improvement on the use of the 2001-2002 net short, as it reflects DWR's then-current projections over the longer term, and more closely corresponds to the length of the contracts that DWR was signing. As a proxy for DWR's state of mind, this approach may not be bad, but its ultimate accuracy is likely to be worse than the more recent forecasts.⁹ Neither the current forecast nor the historical forecast is ideal, and while both have benefits and flaws, it is difficult to determine which would be the lesser of two evils. Ultimately, it is not clear that any forecast in the record of this proceeding is really any good, and we decline to base our allocation on the available forecasts.

We cannot predict the future, and in this case the past is also of little help, as the DWR contracts at issue were signed at a time of crisis, confusion, and

⁹ In addition, there was some controversy about the most appropriate source for the historical data and forecasts available to DWR. The best sources appear to be what were referred to as the "Nichols Declaration" and "Prosym Run 19g" but it is not clear what relative weight each of these sources should be given, if any.

uncertainty, rendering our traditional notions of cost causation inappropriate. In large part we are “spreading the pain” of a unique occurrence, for which our standard methods are ill-suited. Accordingly, we must find another way to reach a fair allocation. Fortunately, the parties have provided such a route.

As a guide to evaluating the various allocation methodologies, several parties recommended the use of a “fairness yardstick” or “fairness metric,” against which allocation proposals could be measured.¹⁰ Not surprisingly, there was some divergence among the parties among what should be considered fair. Nevertheless, given the problems of the other methods proposed in this proceeding, the fairness metrics appear to provide the best avenue for developing a fair and equitable cost allocation.

In fact, it is quite informative to look at the fairness metrics as well as actual current and recent historical allocations.¹¹

Source/Method	Allocation to:		
	PG&E	SCE	SDG&E
D.02-12-045 ¹²	44%	42%	14%
Interim 2004 ¹³	40%	47.3%	12.7%
PG&E Metric ¹⁴	39%	48.4%	12.5%
SCE Metric ¹⁵	48%	36%	16%
ORA Metric ¹⁶	39.2%	48.3%	12.6%

¹⁰ In essence, the “Utility Allocation Percentages” in the proposed settlement also represent a fairness metric. (Motion of Settling Parties, p. 4.)

¹¹ For purposes of this table, Prosym Run 43 was used, as that run provided the basis for the parties’ litigation proposals, including their fairness metrics.

¹² Allocation for 2003.

¹³ Applying same method adopted in D.02-12-045.

¹⁴ Based on method adopted in D.02-12-045.

¹⁵ Based on forecasts of net short (SCE Opening Brief, p. 11).

Settlement Metric	43.6%	42.6%	13.8%
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It is particularly interesting to note that two parties other than SDG&E (PG&E and ORA) were willing to argue that an allocation as low as approximately 12.5% would be appropriate for SDG&E. With the exception of SCE's Metric, the range of allocations recommended or previously adopted for SDG&E is also relatively narrow. Since all of the principles upon which we might base an allocation methodology appear to be flawed, we will simply use the concurrence of the parties to establish fixed allocation percentages that will be applied to the cost of DWR's contracts. Accordingly, we adopt an allocation of 12.5% for SDG&E.

There is less concurrence regarding the relative shares to be allocated to PG&E and SCE, but considering the levels of PG&E's Metric, SCE's Metric, and the Settlement Metric, it is appropriate to allocate the remaining 87.5% equally between the two. Accordingly, we adopt an allocation of 43.75% each for PG&E and SCE.

Use of fixed allocation percentages is consistent with the recommendation of SDG&E. According to SDG&E, fixed percentages eliminate the ability of utilities to shift costs to each other via their dispatch decisions (SDG&E Opening Brief, pp. 17-19), and also reduce the motivation to relitigate the allocation methodology (SDG&E Reply Brief, pp. 23-24).

¹⁶ Based on method adopted in D.02-12-045.

VI. Costs to be Allocated

Finally, it is not enough to simply determine allocation percentages. We must also clearly identify the specific costs to which those allocation percentages are applied. The categories of costs that have been discussed in this proceeding include total contract costs, unavoidable costs, avoidable costs, and above-market costs. Total contract costs include the avoidable costs, unavoidable costs, and above-market costs of the DWR contracts. For each individual contract, however, the relative proportions of each of these components can vary.

Avoidable costs were allocated on a CFC basis in D.02-09-053. In general, the parties have not recommended changing that allocation. In D.02-12-045, we allocated total costs and subtracted out the previously allocated avoidable costs to come up with a residual allowance of fixed costs. SDG&E recommends continuing to use that method. The settling parties prefer to base an allocation on above-market costs. While we do not adopt the above-market cost methodology, its proponents raise some valid criticisms of the calculation approach used in D.02-12-045.

SCE argues that the method used in D.02-12-045 (and advocated by SDG&E) treats avoidable contract costs as an economic burden, when in fact such costs should be considered an economic benefit: “Avoidable contract costs should only be incurred when they are projected to be less than the market value of the energy dispatched. As a result, avoidable contract costs will not be incurred when it is uneconomic to dispatch.” (SCE Reply Brief, pp. 4-5)

SCE correctly points out that the residual calculation approach results in the customers of SDG&E, which has the largest percentage share of dispatchable contract energy, being allocated the smallest percentage share of the unavoidable contract costs. (*Id.*, p. 5.) While SCE does not support a “prorata” allocation, SCE

argues that if a prorata allocation is used, the current residual calculation approach is unfairly biased. (*Id.*)

According to SCE,

The Commission has already properly determined that avoidable contract costs should follow the physical contract allocation to ensure that least-cost incentives are maintained. As such, it is not necessary or useful to aggregate the DWR revenue requirement to implement a “prorata” allocation, and then residually determine the allocation of unavoidable contract costs by subtracting forecast avoidable contract costs. This proceeding has been established to allocate DWR’s unavoidable contract costs. If a prorata methodology is to be implemented, it should be on the unavoidable contract costs only, and not incorporate avoidable contract costs which are actually an economic benefit to customers. (*Id.*, pp. 5-6.)

While we do not necessarily agree with every aspect of SCE’s argument, the criticism of the residual calculation approach is generally well founded. In addition to the problems noted by SCE, in the course of this proceeding we have found that the parties are indirectly re-litigating the allocation of the avoidable costs of DWR’s contracts, as the total cost approach we adopted in D.02-12-045 creates a direct link between the allocation levels of the unavoidable and avoidable costs.

Accordingly, we adopt SCE’s alternate recommendation that the allocation factor be applied only to the unavoidable cost component of the DWR contracts.¹⁷ Ironically, SDG&E made this same proposal during litigation of the 2003 revenue

¹⁷ ORA proposes that gas tolling costs associated with must-take contracts be considered avoidable costs. We rejected this same proposal in D.02-12-045 (p. 17), and we reject it again here.

requirement allocation, but the Commission rejected it at that time. (D.02-12-045, pp. 12-14.) The methodology the Commission adopted for 2003 (and that SDG&E continues to advocate) actually resulted in a more favorable allocation for SDG&E than SDG&E's own. (*Id.*, Table A, p. 18.)¹⁸

The final results of the allocation methodology we adopt today are reflected in Appendix A.

VII. Surplus Sales

All three utilities propose that the sharing of revenue from surplus sales on a pro-rata basis between DWR and the utilities, as established by D.02-09-053, be eliminated. (See, e.g., SDG&E's Opening Brief, pp. 33-37.) DWR does not oppose the elimination of sharing revenues from surplus sales, but notes that as a result of eliminating the sharing of revenues of surplus sales, all DWR sales would be deemed delivered to retail end use customers. DWR states its willingness to work with the utilities and the Commission to amend the Operating and Servicing Agreements to accommodate a Power Charge calculation that reflects that all DWR power is delivered to retail end use customers.

However, in spite of the agreement between DWR and the utilities on this matter, we cannot change the Operating and Servicing Agreements in this decision, in advance of the necessary filings by DWR and the utilities. The current surplus sales methodology will remain in place for 2004, but we encourage the utilities and DWR to work together to bring the proposed changes before the Commission in the appropriate forum, so that we can implement any

¹⁸ The rate increase that SDG&E will see as a result of the allocation we adopt today is largely a reflection of the favorable allocation that SDG&E received for 2003.

agreed-upon changes concurrently with our allocation of DWR's 2005 revenue requirement.

VIII. Utility Specific Balancing Accounts

The utilities recommend the establishment of utility specific balancing accounts that would track the revenues received by DWR from the customers of each utility against DWR's costs (or revenue requirement) for those same customers. (See, e.g., SDG&E Opening Brief, pp. 37-38, SCE Opening Brief, pp. 46-47.) DWR has indicated that it is willing to create and maintain these accounts. We direct the three utilities to work with DWR to work out the details of implementing utility specific balancing accounts, consistent across all three utilities, and in compliance with all applicable statutes. The three utilities and DWR should coordinate with Energy Division staff in developing the details of the utility specific balancing accounts. The utilities shall submit advice letters within 75 days of this decision, describing the utility specific balancing accounts and how they work.

IX. Future Proceedings

We intend to close this proceeding shortly. For future DWR submissions, such as its annual revenue requirement, we are considering opening one proceeding each year to address any and all DWR submissions, and related issues. In comments on this proposed decision, parties should provide any suggestions or recommendations they have for how such a proceeding would best work.

X. Rehearing and Judicial Review

This decision construes, applies, implements, and interprets the provisions of Assembly Bill (AB)1X (Chapter 4 of the Statutes of 2001-02 First Extraordinary Session). Therefore, Pub. Util. Code § 1731(c) (applications for rehearing are due

within 10 days after the date of issuance of the order or decision) and Pub. Util. Code § 1768 (procedures applicable to judicial review) are applicable.

XI. Assignment of Proceedings

Loretta M. Lynch and Geoffrey F. Brown are the assigned Commissioners and Peter V. Allen is the assigned Administrative Law Judge in these proceedings.

XII. Comments on Proposed Decision

The proposed decision of the ALJ was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Commission's Rules of Practice and Procedure. Comments were received from _____. Reply comments were received from _____.

Findings of Fact

1. Annual re-litigation of an allocation methodology to be applied to DWR's revenue requirement is neither efficient nor necessary.
2. DWR's supplemental revenue requirement determination was based on Prosym Run 45.
3. The Proposed Settlement's use of the costs-follows-contracts methodology is not equitable.
4. The Proposed Settlement relies upon a flawed forecast of future above-market costs.
5. The Proposed Settlement's use of the 2001-2002 net short positions of the three utilities as a basis for future cost allocation is not equitable.
6. No party's litigation position proposed an equitable allocation methodology.
7. The pro rata allocation methodology adopted in D.02-12-045 was generally equitable, but the residual calculation approach used in that decision was flawed.

8. Several parties proposed fairness metrics for evaluating allocation methodologies. Avoidable DWR contract costs were previously allocated in D.02-09-053.

9. Avoidable DWR contract costs were previously allocated in D.02-09-053.

10. The utilities proposed, and DWR agreed to, the implementation of utility specific balancing accounts.

Conclusions of Law

1. A permanent allocation methodology for DWR's revenue requirement should be adopted.

2. The Proposed Settlement is inconsistent with D.02-12-045.

3. The Proposed Settlement is not equitable, and should not be approved.

4. The parties' fairness metrics provide an equitable basis for determining a permanent allocation.

5. The pro rata allocation methodology adopted in D.02-12-045 provides a reasonable starting point for a permanent allocation.

6. The residual calculation approach used in D.02-12-045 should be replaced with a separate calculation of fixed costs.

7. DWR should establish utility specific balancing accounts.

8. This decision construes, applies, implements, and interprets the provisions of Assembly Bill (AB)1X (Chapter 4 of the Statutes of 2001-02 First Extraordinary Session).

O R D E R

IT IS ORDERED that:

1. The allocation methodology adopted today for Department of Water Resources' (DWR) revenue requirement is permanent.
2. The Proposed Settlement is not adopted.
3. The allocation of variable costs previously adopted in Decision (D.) 02-09-053 remains unchanged.
4. The allocation of fixed costs of DWR's revenue requirement is: Pacific Gas and Electric Company - 43.75%, Southern California Edison Company - 43.75%, and San Diego Gas & Electric Company - 12.5%.
5. Pursuant to D.04-01-028, the allocation methodology is applied retroactively to January 1, 2004.
6. DWR and the utilities are directed to work together to implement utility specific balancing accounts, as described above.
7. The details of the allocation methodology we adopt are set forth in Appendix A.
8. Pub. Util. Code § 1731(c) (applications for rehearing are due within 10 days after the date of issuance of the order or decision) and Pub. Util. Code § 1768 (procedures applicable to judicial review) are applicable to this decision.

9. This order is effective immediately.

This order is effective today.

Dated _____, at San Francisco, California.

APPENDIX A

IOU Cost Allocation Summary

Total DWR Power Costs	\$4,859,626,196
Administrative & General Expenses	\$59,000,000
Extraordinary Costs	\$37,054,868
Net Operating Revenues	(\$320,372,326)
Interest Earnings on Fund Balance	(\$32,212,129)
Other Revenues (Contract Settlements, Extraordinary Receipts)	(\$51,896,968)
Net Total of Variable Contract Costs, other Fixed Costs, and Net Revenues	\$4,551,199,641

Cost Allocation	<u>PG&E</u>	<u>SCE</u>	<u>SDG&E</u>	<u>Total</u>
Direct-assign Variable Contract Costs	\$91,240,650	\$175,304,580	\$204,519,570	\$471,064,800
Calculate and Allocate Fixed Costs				
Total Fixed Costs = Total Costs less Variable Costs				\$4,080,134,841
Adopted Allocator of Fixed Costs	43.75%	43.75%	12.50%	100%
Allocated Fixed Costs	\$1,785,058,993	\$1,785,058,993	\$510,016,855	\$4,080,134,841
Less: Off-system Sales	(\$18,078,332)	(\$215,013,323)	(\$39,486,934)	(\$272,578,590)
DWR Reconciliation to State Controller (Table A-1, line 19)	(\$2,910,791)	(\$2,910,791)	(\$831,655)	(\$6,653,237)
Subtotal: Fixed and Variable Costs	\$1,855,310,520	\$1,742,439,458	\$674,217,836	\$4,271,967,815
2001/2002 True-up Amounts (D.04-01-028)	(\$100,590,687)	\$41,308,258	\$59,282,429	\$0
Sub-Total--IOU DWR Revenue Requirement before DA CRS	\$1,754,719,833	\$1,783,747,716	\$733,500,265	\$4,271,967,815
Less: Direct Access Power Charge-Related Revenues	(\$104,312,750)	(\$104,663,900)	(\$32,119,330)	(\$241,095,980)
Total Revenue Requirement	\$1,650,407,083	\$1,679,083,816	\$701,380,935	\$4,030,871,835
Shares of Revenue Requirement	40.9%	41.7%	17.4%	100.0%
Calculation of IOU Power Charge	<u>PG&E</u>	<u>SCE</u>	<u>SDG&E</u>	<u>Total</u>
2004 DWR Delivered Energy (kWh)	21,145,876	21,910,180	7,998,786	51,054,842
Variable Contract Component	\$0.00431	\$0.00800	\$0.02557	\$0.00923
Fixed Cost Component	\$0.08442	\$0.08147	\$0.06376	\$0.07992
2001/2002 True-up	(\$0.00476)	\$0.00189	\$0.00741	\$0.00000
Less: Off-system Sales	(\$0.00085)	(\$0.00981)	(\$0.00494)	(\$0.00534)
Adjustment to Operating Account (Table A-1, line 19)	(\$0.00014)	(\$0.00013)	(\$0.00010)	(\$0.00013)
Adjustment to match DWR year-end balance	(\$0.00091)	(\$0.00091)	(\$0.00091)	(\$0.00091)
DA CRS Contribution	(\$0.00493)	(\$0.00478)	(\$0.00402)	(\$0.00472)
Total IOU Power Charge	\$0.07714	\$0.07573	\$0.08678	\$0.07804

(END OF APPENDIX A)